UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

THE BENNETT FUNDING GROUP, INC.	CASE NO. 96-61376 Chapter 11
Debtors	Substantively Consolidated

RICHARD C. BREEDEN, as trustee for
THE BENNETT FUNDING GROUP, INC., et al.

Plaintiff

vs. ADV. PRO. NO. 98-70528A

FIRST NATIONWIDE

Defendant

APPEARANCES:

SAPERSTON & DAY, P.C. Attorneys for Plaintiff 800 First Federal Plaza Rochester, NY 14614-1999	KENNETH ALWEIS, ESQ. Of Counsel
STULTS & BALBER, P.C. Attorneys for Defendant 1370 Avenue of the Americas New York, New York 10019-4602	JARED FORMINARD, ESQ. Of Counsel

Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT,
CONCLUSIONS OF LAW AND ORDER

On November 25, 1998, the Court issued a Memorandum-Decision, Findings of Fact, Conclusions of Law and Order in the above-captioned adversary proceeding (the "November 25 Order"), which granted in part, granted conditionally in part, and denied in part a motion by

defendant First Nationwide ("First Nationwide") to dismiss a complaint filed by Chapter 11 Trustee Richard C. Breeden ("Trustee") pursuant to Rules 7012 and 7009 of the Federal Rules of Bankruptcy Procedure ("Fed.R.Bankr.P."). Presently before the Court are a motion by the Trustee seeking an extension of time to appeal pursuant to Fed.R.Bankr.P. 8002(c), a motion by the Trustee seeking reconsideration of a portion of the November 25 Order, a cross motion by First Nationwide seeking reconsideration of the November 25 Order, and a further cross motion by First Nationwide seeking authorization to appeal the November 25 Order pursuant to Fed.R.Bankr.P. 8002(c).

In his adversary complaint, the Trustee sought to avoid certain payments made to First Nationwide by The Bennett Funding Group, Inc. and/or its affiliated companies (the "Debtors") under § 548 of the United States Bankruptcy Code, 11 U.S.C. §§ 101-1330 ("Code") and equivalent state law, codified as §§ 271-281 of the New York Debtor and Creditor Law (McKinney's 1990) ("NYD&CL"). In support of these causes of action, the Trustee's complaint alleged only that (1) payments in a specified amount were made to First Nationwide; (2) the Debtors were operating a "Ponzi scheme," and (3) the source of the payments to First Nationwide was the "Honeypot," an account consisting of commingled funds obtained from victims of the Ponzi scheme. No additional facts were alleged concerning the relationship between the Debtors and First Nationwide, and no facts are alleged concerning the purpose, function, or reason for the payments.

In a part of the November 25 Order for which the parties have not sought reconsideration, the Court dismissed the Code § 548 causes of action on the grounds that the complaint did not allege any payments within the one-year statute of limitations of the Code. The Court denied the

motion to dismiss with respect to the Trustee's causes of action under NYD&CL §§ 273-275, which sought to avoid the payments as constructively fraudulent transfers. However, the Court found that the Trustee failed to comply with Fed.R.Bankr.P. 7009 with respect to his NYD&CL § 276 cause of action, which sought to avoid the payments as actual fraudulent transfers. Accordingly, the Trustee's NYD&CL § 276 cause of action was dismissed conditionally, unless the Trustee filed an amended complaint in compliance with the terms of the November 25 Order by December 25, 1998. By an Order of the Court dated December 16, 1998, the requirement that the Trustee file an amended complaint by December 25, 1998, was stayed indefinitely pending the outcome of this motion.

In the papers filed pursuant to the present motion, the Trustee alleges that this adversary proceeding is factually identical to numerous others filed against other defendants by the Trustee, so that to the extent that any part of the November 25 Order is adverse to the Trustee, it will become part of the law of the case which may be raised against the Trustee by the other adversary defendants. Because of the potentially wide impact of the November 25 Order, along with the lack of opposition to either party's Fed.R.Bankr.P. 8002(c) motion, each of the cross motions for an extension of time to appeal will be granted.

The Trustee's motion for reconsideration addresses only that part of the November 25 Order which conditionally dismissed the complaint for failure to comply with Fed.R.Bankr.P. 7009. In pertinent part, that part of the November 25 Order held that the particularity requirements of Fed.R.Bankr.P. 7009 are applicable to an avoidance action under NYD&CL § 276; that Fed.R.Bankr.P. 7009 requires that a complaint seeking relief under that section must state with particularity some "nexus" between the transfer and the alleged harm to creditors; and

that no such nexus appeared in the Trustee's complaint. *See* November 25 Order at 5.

The Trustee only seeks reconsideration of the last of these holdings. In essence, the Trustee argues that if he proves the existence of the Ponzi scheme at trial, along with the fact that payments were made from the Honeypot, a reasonable factfinder could conclude without additional evidence that the payments to First Nationwide were made with actual intent to defraud.[1] In support of this proposition, the Trustee relies primarily on a line of cases holding that a prima facie case for actual fraud is stated where it alleged that (1) the transferor of a given transfer was operating a Ponzi scheme, and (2) the transferees were "investors" in the Ponzi scheme. *See In re Randy*, 189 B.R. 425 (Bankr. N.D. Ill. 1995); *In re Agricultural Research and Technology Group,* Inc., 916 F.2d 528 (9th Cir. 1990); *In re Baker & Getty Financial Services, Inc.*, 98 B.R. 300 (Bankr. N.D. Ohio 1987). As support for their holding, each of these authorities cites back to the influential decision of *In re Independent Clearing House Co.,* 77 B.R. 843 (D.Utah 1987), in which it was held that

> A Ponzi scheme cannot work forever. The investor pool is a limited resource and will eventually run dry. The perpetrator must know that the scheme will eventually collapse as a result of the inability to attract new investors. The perpetrator nevertheless makes payments to present investors, *which, by definition, are meant to attract new investors*. He must know all along, from the very nature of his activities, that investors at the end of the line will lose their money. Knowledge to a substantial certainty constitutes intent in the eyes of the law, *cf.* Restatement (Second) of Torts § 8A (1963 & 1964), and a debtor's knowledge that future investors will not be paid is sufficient to establish his actual intent to defraud them.

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[1] In its November 25 Order, the Court expressly rejected the Trustee's argument that proof of a Ponzi scheme alone (without proof of the Honeypot) could justify an inference of actual fraudulent intent. That decision did not, however, address the alternate argument that an allegation of a Ponzi scheme could give rise to an inference of fraud when combined with the allegation that the payment was made out of the Honeypot.

Id. at 860. (Emphasis added).

Contrary to the interpretation of the Trustee, the holding of these cases is not that any payment which merely happens to reduce the amount of funds available for unsecured creditors is fraudulent; indeed, such a rule would stretch the Trustee's avoidance powers beyond recognition. Instead, the central insight of *Independent Clearing House* is that a Ponzi payment to an investor is fraudulent because it has both the purpose and the effect inducing new investors to enter the scheme, thus causing the cycle of fraud to grow even larger and making its inevitable collapse even more devastating for the creditors.

Had the Trustee alleged that First Nationwide was as an investor, or even the functional equivalent of an investor, the Court would have little hesitation in ruling that the complaint satisfied the requirements of Fed.R.Bankr.P. 7009. *See Breeden v. Gloucester Bank & Trust Co.*, *(In re The Bennett Funding Group, Inc.)*, Adv. No. 98-70037, Slip. Op. at 21-22 (Bankr. N.D.N.Y. February 9, 1999). Similarly, the Trustee might have stated a prima facie case for actual fraud by alleging that the payment secured some service which operated to expand the Debtors' wrongdoing. *See Breeden v. Walnut Street Securities*, Adv. No. 98-70256, Slip. Op. at 7 (Bankr. N.D.N.Y. November 24, 1998). Alternately, the Trustee might have pled any one of a number of additional theories of how the payment to First Nationwide was designed to separate fraud victims from their money. The Trustee has done none of this.[2] Instead, the

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[2] In his supplemental memorandum of law, the Trustee notes that in a Ponzi scheme, "[p]ayment to investors is necessary to perpetuate the Ponzi scheme and the payments to the defendant are alleged in the Complaint not only to have been made as part of the Ponzi scheme but also to have been made from the central commingled account through which the Debtors conducted the Ponzi scheme." The Court notes, however, that the Trustee's complaint nowhere alleges that First Nationwide was an "investor."

complaint leaves First Nationwide in the position of having to respond to an extremely broad-based allegation of fraudulent intent, without having the slightest indication of what its own role in the fraud is alleged to be. This is precisely the evil that Fed.R.Bankr.P. 7009 was designed to prevent, and the Court will accordingly not reconsider its prior ruling.

In its cross motion, First Nationwide urges the Court to reconsider that part of its November 25 Order which held that it was unnecessary for the Trustee to allege scienter on the part of First Nationwide in order to state a prima facie case for actual or constructive fraud under the NYD&CL. However, it appears that the arguments raised by First Nationwide on this point are not significantly different from the arguments raised and discussed at considerable length in the November 25 Order. As such, they are more properly addressed on appeal than through a motion for reconsideration.

Based on the foregoing, it is hereby

ORDERED that the motion of the Trustee and the cross motion of First Nationwide seeking an extension of time pursuant to Fed.R.Bankr.P. 8002(c) for filing a notice of appeal of the November 25 Order is granted, and that the extended deadline for the filing of such notice shall be fixed at ten (10) days from the date of this order; and it is further

ORDERED that the motion of the Trustee and the cross motion of First Nationwide seeking reconsideration of the Court's November 25 Order are hereby denied in their entirety, except insofar as such order has been previously modified by the Court's order of December 16, 1998; and it is further

ORDERED that the stay imposed by the Court's Order of December 16, 1998 shall remain in effect pending further order by the Court or of the appropriate appellate court.

Dated at Utica, New York

this 27th day of April 1999

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STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge